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Oral and written evidence

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The Treasury Committee

The Treasury Committee is appointed by the House of Commons to examine the expenditure, administration and policy of HM Treasury and its associated public bodies.

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Jim Cousins MP (*Labour, Newcastle upon Tyne Central*)
Angela Eagle MP (*Labour, Wallasey*)
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Committee staff

The current staff of the Committee are Colin Lee (Clerk), Fiona McLean (Second Clerk), Dominic Lindley and Andrew Staines (Committee Specialists), Fiona Channon (Committee Assistant), Mandy Sullivan (Secretary) and James Clarke (Senior Office Clerk).

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Taken before the Treasury Committee

on Thursday 13 October 2005

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Mr John McFall, in the Chair

Lorely Burt
Jim Cousins
Angela Eagle
Mr Michael Fallon
Ms Sally Keeble

Susan Kramer
Mr Andrew Love
Kerry McCarthy
Mr David Ruffley
Mr Mark Todd

Witness: Mr David Walton, External MPC Member, examined.

Q1 Chairman: Mr Walton, good morning to you. You come to us in a different guise. We are familiar with the work that you have done as an adviser to the Treasury Committee and we are grateful for that work, but you are here for a formal examination this morning. First of all, could I ask you to tell us how you were appointed to the MPC, when did the appointment process begin and what did it entail?

Mr Walton: I was formally announced, I think it was, on the last Thursday in May and the formal approach came from Gus O'Donnell on the Monday prior to that, so about three days before it was announced. I guess I had been informally approached probably a year or so before that just along the lines of might I at some point be interested in serving on the MPC, but obviously nothing about timing or anything else, and I had expressed an interest at that point. Then it went pretty quiet really, so it all happened, as I think most of these things tend to, with a bit of a rush at the end.

Q2 Chairman: Why have you decided to work just a three-day week as an external member? I note that you have accepted the post of visiting research professor in monetary economics at Oxford University on a part-time, one-day-a-week equivalent basis, so what do you have planned for the remaining one day or indeed the remaining three days of the week?

Mr Walton: Well, it was not my choice to work three days a week. This is something which has been decided by the Court of the Bank of England, that external members should only work three days a week. Certainly my intention when I was first approached was that I would be working more than that, but having accepted though the three-day-a-week appointment, I was thinking what else could I do with my time and this opportunity came along at Oxford University which I think is very complementary and it enables me to do some research which hopefully will be quite related and quite relevant to some of the issues that we debate on the Committee. I think that is probably the maximum you can do. Frankly, there is no way that

I could say to the Bank of England that I am only doing Monday, Tuesday and Wednesday; you have to be pretty flexible.

Q3 Chairman: You do not want to give them the benefit of scrutinising the economic policy of the UK as just a half a week's job?

Mr Walton: As I say, this is something that the Court of the Bank of England has decided, not me.

Q4 Mr Fallon: I am glad you have been able to fill in the rest of your time! Now, you have been watching monetary policy for many years. Since the Bank took responsibility in 1997, which of their decisions have you disagreed with?

Mr Walton: I am not sure that I can give you chapter and verse on that, to be honest. I think, by and large, and you can see from the outcomes, that the way the policy has been set has been very appropriate. I am sure there has been the odd decision and I seem to remember the very last interest rate cut, I guess it was, during the 2001 downturn. That was something which perhaps seemed a little bit too much at the margin, but all these things are very marginal and it is very hard to quibble over the odd quarter of a point in interest rates.

Q5 Mr Fallon: And you do not disagree either with the general caution of the MPC, the criticism that it has, if anything, been over-cautious?

Mr Walton: Well, I think the record disproves that it has been over-cautious. Inflation, which, as you know, is the mandate given to the MPC, has been very close to the target. Certainly when RPIX was the target, inflation pretty much averaged $2\frac{1}{2}\%$ for the whole of the time that the Bank was independent. CPI inflation started below target, but has moved to just a bit above target, so it is very hard to say that the Bank of England has failed in either direction to achieve the inflation target. Therefore, it would be hard, I think, to say that they have either been too cautious or too gung-ho.

Q6 Mr Fallon: In your answer to question 9, you do seem rather gloomy about economic prospects in the near term. You talk about downside risks, that, as an

investment prospect, it is very uncertain, surveys of investment intentions having eased, companies remaining reluctant to invest. Given that assessment of the risks, why did you vote for no change at the September meeting?

Mr Walton: Well, when I joined the Committee back in July, we had been faced with a lot of new information. There had been very substantial revisions to the national accounts and that was one of the reasons which made me think that a rate cut was appropriate in August, but you clearly need also to allow time for interest rate changes to have their effect on the economy. It is also the case, I think, if you look at survey information and if you look at labour market data, that the economy looks to be growing a little bit below trend, but perhaps not as much as is currently suggested by official estimates. I certainly did not think, even when I was voting for a rate cut in July and August, that there was any great panic or that there was any great need for substantial cuts in rates. Indeed I would say that when we were debating this in the Committee in July and August, there was a much clearer view within the Committee that the market had got ahead of itself in pricing several rate cuts. The Committee was very much debating the merits of one cut at that time.

Q7 Mr Fallon: You have written in the past that the best way to smooth inflation is to smooth demand growth. Can we now expect your vote on the MPC to respond properly to below-trend economic growth?

Mr Walton: Well, I think you need to judge both what is happening to demand and indeed what is happening to supply, which is the point that the Governor was quite at pains to stress earlier this week. In general, you would hope that the supply side of the economy is growing quite smoothly through time, but there are occasions when that may not be the case and, in particular, if you had a big oil price shock, that could certainly cause some disruption. I think what is important in general is to try and keep demand more or less in line with supply, but it is not straightforward at any point in time, I think, just to say, "This is the latest official number. I believe that totally and, therefore, that has a mechanical effect on my interest rate decision". A lot is going to depend, therefore, on reaching a judgment of the balance of demand versus supply and what that is likely to mean to inflation as you look forward over the next couple of years.

Q8 Susan Kramer: You have pointed out that inflation at 2.4% is only a little bit above the Government's target, but do you have any concerns over the speed with which that has risen over the last 12 months?

Mr Walton: It certainly has risen much more sharply than the MPC was expecting before I joined the Committee. Some of that, I think, as you look at it in a bit more detail, is due to the fact that actually inflation turned out to be surprisingly low in the final months of last year. Inflation was running around 1½% and then it dipped towards 1% and then it has

suddenly risen quite sharply. I think it is probably right to smooth out some of that dip that took place during the second half of last year, but, even if you do that, it is still the case that inflation has risen by a percentage point or so and, as best I can tell, oil prices account probably for only about ½% rise in inflation, so there is still another ½% to be explained and we do not know for sure what the reason for that is. It may be that the economy which was growing pretty rapidly during 2003 and the first half of 2004 may have created some inflationary pressures which are still being felt at the current time and, similarly, the slow-down that we have seen since the middle of last year may well be helping to reduce inflationary pressures going forward. It may also be that there are just some idiosyncrasies in the data. For instance, if you look at RPIX inflation, that has only risen by ½% from its low point. Therefore, I would not want to read too much into very short-term movements in inflation. I think you really need to try and smooth out a bit of the volatility that occurs from month to month and try to come up with a balanced view for what the inflation prospects are likely to be over the next couple of years or so.

Q9 Susan Kramer: Could you just explore that a little bit more for us? I am trying to understand if basically the other sort of ½%, as you are suggesting, and the other half the inflation growth is a sort of home-grown problem and I am just wondering why CPI inflation has risen faster in the UK over the last 12 months than in any of the other major Eurozone countries?

Mr Walton: Basically inflation has risen by about 1¼% from its low point. Part of it, I think, was just a kind of base effect where inflation was unusually low in the early part of that period, part of it is certainly due to oil and part of it is due to parts of the service sector having seen quite a sharp rise, so, for instance, within the CPI, financial services inflation has been rising at around 11% over the past year, up from about 3% a year ago and that in itself has contributed about 0.2% inflation. Now, whether that is likely to persist going forward, I think, is probably quite doubtful. There have certainly been oil price effects, there have been other, non-oil import price effects, almost certainly there have been some demand effects as well from this previous period of rapid growth, but there are probably just some quirks in the data and it is going to take a few more months, I guess, before we can really get a very clear picture as to which of those is the most important.

Q10 Susan Kramer: By their own admission, in recent years the MPC has been using monetary policy to stimulate domestic spending to offset weaknesses in the external environment. Given accumulating imbalances in the economy, is this strategy now hitting its natural limits and could the MPC react to continued weakness in the external environment by cutting the interest rates to stimulate consumer spending or are we basically running out of that tool, if you like?

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Mr Walton: I think it is certainly right to say, particularly when the global economy was very weak during 2001 and 2002, that interest rates were cut pretty aggressively in order to help boost domestic demand to offset that external weakness. That has had some by-products. It has meant that house prices have risen very rapidly and it has meant that household debt has risen sharply. Whether that reduces the effectiveness of policy going forward, I think, is a moot point. In some sense, you could say that if people have more debt, then actually they are more sensitive to interest rate changes, but equally I think you can say that people may come to the conclusion that they have quite enough debt, thank you, and even if you were to cut interest rates, they would not necessarily want to go out and borrow more to support spending. My honest answer, therefore, is I do not know whether the effectiveness of monetary policy has changed. My gut feel is that it probably has not and that the MPC, if it is to hit the inflation target over the medium term, will need to try and keep demand broadly in line with supply and use interest rates as the tool to try to achieve that.

Q11 Susan Kramer: The accelerator is not at the bottom yet, not to the floor yet?

Mr Walton: I do not think so.

Q12 Mr Ruffley: Mr Walton, you told the Lords Economic Affairs Committee in March last year that the switch to an inflation target based on the CPI was, "a bit of a sop to the pro-EMU lobby", and it was not clear that it was the appropriate thing to do, "to switch from a measure of RPIX to another measure which does not include any measure of housing costs at all". Eighteen months on, have you revised your views on that change from RPIX to CPI?

Mr Walton: Well, I think the one thing to be clear about, sitting here today, is that the Chancellor sets the inflation remit for the Monetary Policy Committee and he has chosen a 2% target for consumer price inflation, so whatever the merits of different measures or different levels, that is the number that we are aiming for on that particular measure. I think when I gave evidence to the House of Lords Committee my basic point really was that the existing framework worked extremely well, RPIX inflation had been very close to target and the economy had been very stable, so if that was working well, why change? That was really, I think, the main thrust of my argument.

Q13 Mr Ruffley: But are there strong arguments for including some measure of housing costs in the CPI?

Mr Walton: Yes.

Q14 Mr Ruffley: I know the Chancellor set the framework, but I want to know what you think technically about the CPI and whether or not housing costs should be included.

Mr Walton: I think some measure of housing costs should be included. Now, it is not clear that the measures which were in the RPI are the right

measures and it is not at all clear that housing depreciation measured by house price inflation is a particularly good measure of housing costs. Rent is probably the ideal measure, but there have always been problems in having very good data on the market rented sector, though I suspect that has become rather easier in recent years. It is also the case that, as you look across continental Europe, the treatment of housing costs is just very different from country to country which is actually why it is excluded from the consumer price index in the first place, because it is very difficult to come up with some harmonious treatment. Now, there are plans afoot and there is a working party, I think, going on at Eurostat to try and come up with a common treatment of housing costs and presumably at the point that they reach agreement, then that will get reflected in the CPI and I think it will be appropriate at that point.

Q15 Mr Ruffley: Does that imply that there are current weaknesses in the CPI regime as it operates in the UK at the moment?

Mr Walton: Well, you know, there are weaknesses and strengths of any particular measure. As I say, I think it is a weakness not to have some measure of housing costs, but you can balance that against the strengths. The way the data are aggregated together, the geometric averaging of data rather than arithmetic averaging, I think most, if not all, statisticians would agree that is a far better way of aggregating data because it takes account of the fact that if prices are rising very rapidly, people will tend to substitute away from those particular services towards cheaper ones in a way that the arithmetic averaging does not actually do. I think there are pros and cons to all measures and they are all in a sense different measures trying to measure approximately the same thing, but no particular measure is going to be perfect.

Q16 Mr Ruffley: There has been quite a lot of commentary on this change and how it affects public perception. It has been written about quite extensively and I think the man in the street probably picks this up just reading the broadsheets, that the upshot of the change to CPI does show inflation to be well above target or above the 2% target, but, according to the previous approach, RPIX, which everyone was comfortable with and you said you were comfortable with, it was working and if it ain't broke, don't fix it, on that measure, RPIX, it is below target. Therefore, it raises interesting questions of public perception, does it not, because you could argue that RPIX, if that was a perfectly good measure up until recently, is now below target and that would indicate that inflationary pressures were not great and, therefore, would maybe nudge the MPC towards cutting interest rates, whereas we now know why you are not likely to do that, because, by and large, inflation, on the CPI measure, is above target, so there is this perceptual problem, is there not?

Mr Walton: I think there are two things. As I said right at the start, it is the Chancellor who decides on what measure we target and we have to accept that and conduct policy accordingly, so whatever questions you may have about the precise measure, the fact of the matter is that we do not have this debate on the MPC because we are told what the measure is. I think that is a very good part of the institutional structure and it helps to ensure that there is accountability, so I think that is one thing. The second thing I would say, though, is that you should not read too much into the current rate of inflation. What we are trying to do is set interest rates in order to affect inflation over the next one, two, three years and the current rate of inflation really tells you very little about where inflation is likely to be heading over that period. A lot of the sorts of differences between different measures are likely to come out in the wash as you look forward over the next couple of years and let me give you one example. In the RPI you have second-hand car prices only, whereas in the CPI you have new car prices and second-hand car prices. Now, second-hand car prices have been falling by about 6 or 7% a year whilst new car prices have been rising by about 1½%. Now, who knows precisely what is going to happen, but it is quite likely that you cannot maintain that differential in new and second-hand car prices for ever and that probably those two measures will converge which will tend to mean, therefore, that the difference which is being created at the moment between RPI and CPI will also tend to disappear. There are lots of different examples that you could come up with which, as I say, when looking out over two years, probably are not going to be that important in determining where the path of inflation is going, but can be very important at any point in time in helping to explain the wedge that exists between the two.

Q17 Mr Ruffley: That is a very interesting set of answers. Could I paraphrase it by saying that you do not think it is any big deal, the difference between what RPIX is running at and what the CPI is running at, that it is not a big deal, it will all come out in the wash and it will even itself out?

Mr Walton: I think that whether we are looking at CPI or RPIX, I would not expect that to have a very significant impact, if any, on the conduct of monetary policy. It is well known that RPIX of 2½ to a first order of magnitude was broadly consistent with CPI inflation of 2. Inflation at the end of the day is largely a result of the pressure of demand on supply and that balance between demand and supply does not change as a result of which particular measure of inflation you are looking at.

Q18 Mr Ruffley: Could you just give us an indication of what you see to be the most reliable measure of inflationary expectations?

Mr Walton: I think wages probably at the end of the day. There is certainly a whole host of measures of inflationary expectations, things from financial markets, from business surveys and so on, but I think it is not clear that any of those have a

particular leading indicator property, and there is a bit of a tendency for them to move with inflation. At the end of the day, if expectations are becoming removed from the 2% target, then you are probably most likely to see that coming through in a deviation in wage inflation and, in particular, if you saw second-round effects from high oil prices, then I, and I think probably all of the Committee, would be pretty worried about what that would mean for the future outlook for inflation.

Q19 Lorely Burt: I would like to ask about oil prices. To what extent do you think that the increase in oil prices explains the slow-down in UK growth in 2005?

Mr Walton: I think it has contributed in a couple of ways. One is that it has helped to drag down global growth, particularly in the euro-area where euro-area growth prospects have been revised down pretty much in line with UK growth prospects, and the euro-area is obviously a very important trading partner for the UK, so that has been one adverse effect. Then I think domestically there have been really two effects. One is that you have had a hit to household incomes where, to the extent that people have to drive their cars to work, they have to cook and heat their houses, they do not have that much discretion over how much energy they use and if they are suddenly having to pay more for that energy, then it pretty much means that they are going to cut back in some other areas. Therefore, to the extent that oil prices account for, say, ½% of the rise in inflation, then, other things being equal, that has probably hit ½% of household real income growth. Then there may also be an effect on business investment in that when oil prices have risen by such a large amount, that just creates a bit of additional uncertainty about the future outlook for demand and for profitability and that may have been a factor in making companies decide to postpone investment decisions. It is very hard to quantify all of those effects together, but certainly I think the oil price rise is significant.

Q20 Lorely Burt: Surely it must also directly affect costs in a big way in some industries as well, so reducing their profitability and even viability, I would suggest, in some areas?

Mr Walton: Well, certainly a lot of companies that I have met just in my short time on the MPC have talked about the increase in energy costs which they face. Quite typically, they have talked about a 20/25% increase in energy costs to their business and, as you say, that is not easy to deal with and it is certainly very difficult for them to pass that on to the end consumer straightaway. In the end, a lot of these costs will get passed on where companies will try to hold their profit margins reasonably constant and unfortunately it is us, as consumers, who have to bear the brunt of this. When oil prices go up, essentially it is a bit like a tax and consumers are basically having to give more money to oil producers, many of whom are not based in the UK, so inevitably households are going to suffer some fall

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in their living standards relative to what would otherwise have been the case if oil prices remained at these sorts of levels.

Q21 Lorely Burt: In a recent piece of research, you said that, "If the ECB resists cutting interest rates in the face of an oil shock simply because it fears a rise in inflation expectations, it risks fighting the last war". Do you have any similar views about how the MPC should react to a negative demand shock from oil prices?

Mr Walton: Well, I think the key here really is to come up with a view of what is happening to both demand and supply in the economy and also to take account really of what is happening to inflation expectations. In the context of the euro-area, when I wrote that when I was an economist at Goldman Sachs, it seemed to me that domestic demand was extremely weak, inflation expectations were very well anchored, wage inflation had been drifting lower and, therefore, it seemed to me that you should not be too worried about losing control of inflation. Now, in the case of the Bank of England, the Bank of England has actually cut interest rates on one occasion since I have been a member and, at least in terms of my own vote, that was because I thought that demand had slowed by more than the slow-down in supply and I thought that there was a risk, therefore, that inflation was actually going to undershoot the target, looking forward a couple of years. Therefore, I would not ever want to draw one parallel from one central bank to another and indeed I would never in my current position want to pass any judgment on the policies of another central bank; I do not think that would be appropriate.

Q22 Angela Eagle: In terms of monetary policy, you say in your questionnaire that you do not think the framework can be improved upon and that it is pretty much where it needs to be, but in fiscal policy you had some views when you were giving us your advice as a Treasury Select Committee adviser about the Golden Rule not being hit and you said, "Whether you hit the Rule by £2 or £3 billion or miss it by £2 or £3 billion, it makes no difference". You were fairly relaxed about that and you also said, "My feeling is that the Government has in a sense made a bit too much of the fiscal rules". Now that you are poacher-turned-gamekeeper, do you have the same view?

Mr Walton: Well, as I said in the questionnaire to you, I do think it is important to have a fiscal framework and I think that the fiscal framework that has been in place since 1997 has actually been a pretty good one, but, as I did say to you on numerous occasions when I was an adviser to you, the fiscal framework is very important, but it is also important not to make too much out of what are reasonably small magnitudes either side of the Golden Rule. If the Golden Rule over a number of years, eight years or so, is missed by 0.2 or 0.1% of GDP, I certainly hope you would never hold us on the Monetary Policy Committee too responsible if inflation was suddenly 0.1 or 0.2% either side of the

2% target. The framework is very important and it is again obviously for the Government to decide what the appropriate framework is—

Q23 Angela Eagle: But you actually think it is sensible and grown up to be a bit liberal if there is a slight overshoot or undershoot, as indeed would happen?

Mr Walton: Well, to say that the framework has failed if, for instance, over the whole cycle the current account of the budget was in deficit by £1 billion and to say that it had succeeded if it was in surplus by £1 billion, that has never made very much sense to me.

Q24 Angela Eagle: In terms of consumer spending and house prices, the link that the MPC thought there was between house prices and consumer spending, it said in previous reports that it thought it had weakened, but actually since we have had a flattening in house prices, we have actually had a much more serious slow-down in consumer spending. What is your view on the relationship between these two issues now and do you think that the slow-down in consumer spending is actually what we wanted in order to switch into industrial investment or do you think it is actually now a serious downside risk?

Mr Walton: I think that relationship between house prices and consumer spending is a very difficult one, to be honest, because it is just very hard to get any econometric relationship to work over the sample period of the last several years. In particular, if you want to say that you can explain this slow-down in consumer spending growth by virtue of the fact that the housing market has slowed and house price inflation has stabilised, it then becomes very difficult to explain why consumer spending was not booming away when house price inflation was running at 20% or so, so I think that whole relationship is just very uncertain. I think certainly the housing market slowing has played some role. Clearly if the volume of transactions has slowed, that is going to have some knock-on effect to retail spending, to spending on DIY and so on, but I think you can equally explain other reasons for the slow-down in consumer spending: you have had weaker incomes as employment has slowed; you have had this hit to real wage growth as a result of higher oil prices; and also interest rates went up quite substantially. Interest rates went up from 3½% to 4¾% expressly with the intention actually of trying to get the consumer to slow, so the fact that the consumer has slowed should not be a major surprise. Obviously the path from quarter to quarter will always come as a bit of a surprise, but again I caution about reading too much into that given that we need quite a lot more data or revisions of data before we really know what the true picture has been over the past year.

Q25 Angela Eagle: Finally, we have great fashions in economics. We have been through eras where we have had economists describing themselves as

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monetarists, although that is much discredited, Keynesians or neoclassicists. How would you define yourself as an economist and your economic view?

Mr Walton: Do you know, I think these days actually there is an enormous amount of consensus about economics, about macroeconomics. The monetarist revolution of the late 1960s has had a tremendous impact. I do not think anybody believes these days, certainly not on the MPC I doubt, that there is any long-run trade-off between real economic activity and inflation and that was a key tenet of the monetarist principle. Similarly, in modern Keynesian models, they are all forward-looking with rational expectations and at the same time everyone, I think, accepts that prices do not move instantaneously, that they are sticky, which was a key feature of the Keynesian view. Obviously there are fringes, there are people who are very purist about this, but I think that the vast majority of macroeconomists, and I put myself into this, are really part of what is called the “neoclassical synthesis” which is basically a fusion of many of the best ideas from both Keynesian and monetarist economics.

Q26 Ms Keeble: Your former colleagues at Goldman Sachs believe that sterling is over-valued by about 10% on a trade-weighted basis. What is your view? Do you agree with that?

Mr Walton: Well, do you know, I do not really have a view in the sense that trying to forecast exchange rates is very difficult. My former colleagues, as you say, they are paid to forecast the exchange rate and I am really quite glad on the MPC that I am not paid to forecast the exchange rate. What we do have to do though seriously is clearly take account of exchange rate movements. Formally, we do that in the model by spreading the difference between, if you like, the two main popular theories of how exchange rates move. One theory says that the best you can do is really assume that the exchange rate is going to remain where it is at the moment and another says that exchange rates will move to offset interest rate differentials between two countries. Neither is perfect and, as I say, what we have done on the MPC for a long time now has been to split the difference between the two. Now, that is just a working assumption that we condition our forecasts on, but inevitably the exchange rate will move differently from that and, in particular, between May and August the exchange rate did actually depreciate quite a bit and that was one of the factors which was helping to push up inflation in the forecasts which were published in August. Since then, the exchange rate has appreciated, it more or less took out that depreciation, and then it has depreciated again since, so currently we are about $\frac{1}{2}\%$ or so, I think, above the level in the August Inflation Report. The exchange rate movements, they are very difficult to forecast and it is not something that we think we can forecast particularly well, so we have a kind of working assumption and then we have to interpret the developments which actually occur and, importantly, try to understand why they have

occurred because that can also be very important for understanding what the future implications are going to be for inflation.

Q27 Ms Keeble: I understand obviously that predicting in economics, as in other things, is very difficult and you have been quite bold in some of your predictions. For example, looking at the former discussion about house prices, you made some quite bold remarks in evidence to the Treasury Committee in June, though I was not here then, talking, for example, about the savings ratio which is something that people have been reluctant to forecast when you said you thought that if house prices came down, the savings ratio would go up. You must have some views about the exchange rate.

Mr Walton: But all these things are conditional. Certainly if house prices did come down, I would expect that to push up the savings ratio. Whether house prices will come down is, I think, an entirely different question. If domestic demand in the economy really weakens very substantially, then I think it would be a reasonable expectation to think that the exchange rate probably would come down. All of these things are very conditional. In the case of exchange rates, they are also very much determined by what is happening outside of the UK—

Q28 Ms Keeble: Exactly.

Mr Walton:—and these things are just incredibly difficult to have particularly strong views about. Personally I think it would be wrong to base a forecast for inflation over the next two years on a very strong view about the exchange rate. To take the view that the exchange rate is going to appreciate by 20% and, therefore, inflation is going to be all right, we know that would be a pretty rash thing to do, I think, and, by and large, because interest rate differentials are not huge, we assume reasonably modest movements in the exchange rate and I think that is probably the sensible thing to do.

Q29 Ms Keeble: You give a strong view, but could you just give a slight view?

Mr Walton: On?

Q30 Ms Keeble: On future trends.

Mr Walton: No, not really. To be honest, I would rather not.

Q31 Ms Keeble: To what extent do you think the increased sourcing of goods from developing countries could dampen the effect that a decline in sterling would have on import prices?

Mr Walton: This has been a key feature of the economy in recent years, particularly the growth of China where China has produced goods which have been very much cheaper and which have actually helped to reduce domestic inflationary pressures. However, there is a sort of downside to that which is that China growing so strongly has increased the demand for oil which has also increased cost pressures. These globalisation forces, we have to live with them, I do not think we can stand in the way of them and, by and large, world trade is generally

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good for people, so I would expect to continue to see quite powerful forces from China in the longer term acting as a disinflationary force in the UK and not necessarily over the next year or two as China could easily overheat and contribute a bit of inflation to the world economy and indeed to the UK economy, but over the longer term I think there is still quite a lot of benefit for UK consumers from cheaper goods produced overseas.

Q32 Ms Keeble: Obviously it is interesting that you take China because that, for example, has taken all the shoe production out of my own area which obviously then produces some quite different economic pressures. Do you not foresee any sort of natural buffers in terms of the sourcing of goods from developing countries and the assumption that those are going to continue to remain at the cut-throat prices which they are now?

Mr Walton: Clearly nobody wants to see what you are experiencing in your constituency where basically a whole industry is suffering very badly, and textiles has been another industry which has been hit very badly. The key though is hopefully having a flexible enough economy that you can make these adjustments. You certainly cannot preserve in aspic, nobody would ever want to, the industrial structure of the economy that exists at the present time and economies always evolve. Manufacturing has been on a sort of downward trend certainly since the day I was born and I do not think that is something you can stand in the way of and probably nor should you, but clearly what you would want, I think, is a situation where the economy has enough flexibility and there are enough opportunities for people to retrain such that they can move on from that old industry into newer things. Certainly these adjustment costs for particular regions and particular towns, I do not think anyone should underestimate those.

Q33 Mr Todd: Your career history has been around London and serving economic forecasting units of some kind or another. Do you spend much time in the real world where the wealth of this country is created, to put it bluntly?

Mr Walton: One of the nice things actually about coming to the Bank of England is the ability to spend more time, if you like, in the real world. These last two days I, along with the rest of the MPC, have been up in Gateshead and Newcastle meeting quite a few business people and it is very interesting. Manufacturing is often talked about as being under the cosh, but a number of businesses I have met just in the past few days, their business today is just so different from what it was five, six, seven years ago and this is down to the entrepreneurial spirit of the people involved. I think one of the things I am really looking forward to actually of being on the MPC is actually getting out and meeting people. Certainly when you look at the intelligence that the Bank gets from its regional agents, which is something like 8,000 business contacts around the country, that is enormously valuable to the process of setting interest rates each month, not least because it is so

difficult to know whether the official numbers at any point in time are the truth. This is not a criticism of the ONS, but it is just reflecting the reality that it takes time before all the data come in and I suspect that if there is a sudden change in business conditions, we are much more likely to pick it up both through me and other MPC members meeting business people and indeed just through the vast amount of information that we get each month from businesses which is channelled to the MPC via its regional agencies.

Q34 Mr Todd: What sort of message did your Gateshead audience give you?

Mr Walton: Actually most of the people I met, and I met with the representatives of the Engineering Employers' Federation yesterday, most of them were actually quite upbeat about things. In particular, many of them had seen improving export prospects, particularly in Russia and central Europe, interestingly enough, which somewhat betrayed the sort of gloom or it was a bit different from the gloom that certainly I would be hearing much more if I had sat down with a group of retailers. The important thing, I think, is just to make sure that we are always meeting all the representative groups of the economy and never to focus too much on one sector because as soon as you start to become too narrowly focused, then you are almost certainly going to miss the bigger picture, I think.

Q35 Mr Love: Could I go back right to the beginning again when you mentioned about working three days a week. There had been some controversy previously about the support that was given to external members. What is your view about that?

Mr Walton: My honest view is that I think I am incredibly well resourced relative to what I have been used to. I have two economists who work exclusively for me and then there is just the vast wealth of resources within the Bank of England who are focused on trying to make sure that we have reached the right decision each month, so I have absolutely no complaints whatsoever about the degree of resources I have.

Q36 Mr Love: There is a current controversy going on now where there are those that argue about the disappointing growth recently, that there is a level of slack in the economy, that a rate cut could induce an expansion that would not increase inflation. Now, the Governor has pooh-poohed that argument. What is your feeling?

Mr Walton: I am not sure the Governor has pooh-poohed that argument. He set out very clearly in his speech on Tuesday night what the issues are and I think all of us will be thinking very hard about those issues as we come to think about the forecasts that we will publish in the November Inflation Report. There will be a very active debate, I am sure, about all of those issues, as indeed there has been during the first few months of my time on the Committee. I think what I would certainly echo is what the Governor himself said which is that I do not think

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any member of the MPC goes into any round of monthly meetings with a preconception of what we must do for interest rates. It is a case of weighing up all of the evidence, listening to each other's arguments and then coming to a balanced judgment as to what we think is the likely outlook for inflation two years ahead. If inflation looks as though it is going to be too low relative to the target, that means the Committee is likely to vote for a rate cut, if it means that it is going to overshoot then we are in rate hiking territory. As I say, there was clearly a debate in my first two meetings, and quite a close split in the vote, but I think that is behind us now and we are looking forward to the information that we will assess for the next meeting as to whether or not the current stance of monetary policy is appropriate.

Q37 Chairman: A final question: I note from the Goldman Sachs' publication *Euroland Weekly*, 3 June 2005, you have written in that, it was very recent.

Mr Walton: That was my last piece, I think.

Q38 Chairman: You noted the ECB holding a press conference directly after each Monetary Policy meeting meant that "... Adopting a regular real time communication tool should, in principle, give the ECB a communication advantage over other central banks". Given that statement, would you then be in favour of holding a press conference after every MPC meeting?

Mr Walton: I would not actually.

Q39 Chairman: You have changed your mind in two months!

Mr Walton: No, I said in principle it gives a communication advantage.

Q40 Mr Ruffley: Sounds like a politician.

Mr Walton: The reason I would not be in favour is the following. I think the set up at the MPC is different from the ECB. On the MPC, as you know, we are all individually accountable and it would be very hard, I think, not impossible given the Governor's qualities but it would be hard for the Governor, off the cuff, to summarise all of the very detailed discussions and views that we will have been debating just a few minutes before that press conference. The reason I have come to this view as much as anything is that we now spend, all of us, quite a bit of time each month looking at the minutes, making sure that the minutes convey accurately the views of the different members and also trying to make sure the minutes summarise the arguments well and that is much easier to do when you have had a few days to think about it. I think the UK system where the minutes are published two weeks after the meeting—well before the next meeting—provide a very good form of communication to the outside world and financial markets. The ECB, if they had that same system of publishing minutes, that would also be very good for communication.

Q41 Chairman: After a leisurely summer, two months, you have changed your mind, there is a complete personality transformation. You have told us a lot this morning, Mr Walton, but you ain't going to change your mind that this is a good time to buy second-hand cars, are you, so I can tell constituents?

Mr Walton: It does not feel as though I have had a leisurely summer and I have never given advice on second-hand cars!

Chairman: Can I thank you for your appearance this morning. It has been very valuable to us. Thank you for your previous work as the Committee's specialist adviser and we wish you every success with your appointment on the MPC.

Witness: Mr Paul Tucker, Executive Director: Markets, Bank of England, examined.

Q42 Chairman: Mr Tucker, welcome to the Committee again. You are an old hand, you have been before the Committee before. You do work a five-day week, is that correct?

Mr Tucker: Yes, I do; in fact five is an aspiration.

Q43 Chairman: That is good. Congratulations to you on your reappointment for a second three-year term. Could you tell us if any reports or assessments of your performance were prepared before your reappointment?

Mr Tucker: I honestly do not know, Chairman. I heard from the Governor that I was going to be reappointed. I do not know what the process was behind that. As part of my duties as an Executive of the Bank we have an assessment process. That obviously covers all the other parts of my job and during that the Governor was very positive about what I have been doing on the MPC.

Q44 Chairman: When was your last assessment?

Mr Tucker: At the end of last year.

Q45 Chairman: What do you see as your biggest contribution to the work of the MPC in your three-year term?

Mr Tucker: I think, if I had to pick one thing, it is maintaining focus on the medium-term outlook and placing emphasis on a strategy rather than just on one decision at a time. If I can give you an example of this, if you think to the back half of 2003 when interest rates had been cut for a while. As I think one of you said earlier, perhaps Ms Eagle, we had been stimulating demand to offset weakness from abroad, and as the world economy recovered it was clear that we were going to need to gradually withdraw that stimulus; we were at 3½%. I wanted to make it as clear as we could, both via the minutes—and I did so via an interview and I think also in a speech—that if the economy travelled more or less as we expected then interest rates should be gradually nudging up.

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That is one example, I think there will be others too. I think that focus always has to go on the medium term and it has to be beyond the next meeting. The point about month by month decisions is that one has to be prepared completely to revise one's views on a month to month basis but the view one takes is not just about the next 30 days.

Q46 Chairman: What have you learned most in your three year term?

Mr Tucker: I have put some of the things in the written submission to you. I think there are lots of lessons. One is the importance of being fairly clear about strategy without being overly precise or nice about it or closing one's mind to that. The second one is this question of precautionary cuts or insurance cuts; July 2003 was an example of that. I think there can be circumstances where it is right for the MPC to take a bit of a risk on the one front, in order to head off a risk on another front. We need to be pretty clear about what we are doing in those circumstances because if we take out insurance we may need to take back the insurance at a certain point and our explanation needs to be consistent over the months. I think we managed that in 2003 between July and October/November. I think it was demonstrated to us, certainly to me, that it is not an easy exercise.

Q47 Kerry McCarthy: You have spoken fairly frequently about the problems caused by the potential risks posed by the development of new markets in, for example, things like credit derivatives, inflation swaps and so on. You have also talked about the time lag between the growth of these new financial innovations and the regulators catching up, the control environment catching up. What risk do you think this poses to financial stability and what areas do you think regulators need to pay special attention to?

Mr Tucker: If I start with the current risk. Some of the markets that have grown up in the last few years grew so rapidly that the back office controls—the underpinnings, the plumbing—did not keep touch, did not keep track with those developments. And what that means is that if something really nasty happened, it would be nastier. We started to highlight that really from 2002, about five years ago, and I think there has been an increased awareness of that, not just in this country but in the States and elsewhere too, and I think it is being tackled now. There is a big lesson in it which is that financial institutions innovate like fury; they cannot predict which of their innovations are going to really, really take off; but once they start to see that they need to rapidly and determinedly move to make sure that the proper controls are there. That costs money and they ought to be prepared to spend the money when they have got a success story. The other point I would like to make, if I may, is that the innovation over time is, I think, very positive for the economy and for the international financial system because it is allowing risks to be dispersed more effectively than before. As I say, over time, that should mean that the system is

better protected against nasty developments. So net, I think, these are positive things but there needs to be a bit of care always in their implementation.

Q48 Kerry McCarthy: It does surprise me somewhat you say that in 2002 you realised this was a serious problem and started taking steps to address it. Throughout the 1990s, from Barings onwards, there was a series of problems caused by derivatives trading and I would have thought the issue of the importance of signing trade confirmations was important to make sure the back office was keeping up with the front office, and indeed that the regulators were keeping up with what both the front and back office were doing. I would have thought that would have been flagged up pretty clearly almost a decade earlier.

Mr Tucker: I meant a rather specific thing in that around 2001–02. You could see this particular market growing and so signalling that those questions, for precisely the reasons you say, might need to be addressed on that front. I should also make it clear that our interest is in the system as whole. We are not regulators, that job falls to the FSA. We are not in a position where we can go to individual firms and say, “Show us your back office controls, are those keeping up?” I think our role is, through our intelligence network, to identify these issues and flag them, and that we have endeavoured to do and on that front I think we have done it.

Q49 Kerry McCarthy: I appreciate the FSA is the regulator. It is obviously important that you are aware of the extent to which the FSA is able to regulate the bank's financial institutions are complying in order to be able to assess the potential risk to the stability of the system. Presumably there is an on going dialogue on that basis?

Mr Tucker: Absolutely, and I think that active measures have been taken by the FSA, together with regulators in other countries, to tackle just this issue. And the communication between us on this kind of thing, and indeed with the Treasury, is good via a body called the Tripartite Standing Committee, which was created in 1997 precisely to cater for the need for communication between the three of us.

Q50 Kerry McCarthy: Moving on: the Bank is currently undertaking a review of its operations in sterling money markets, and I think you have said that the reformed system will be in place in March to June next year, is that right? Would you be able to give us an update on progress?

Mr Tucker: Our hope and target is still March to June next year. I am hoping that we will be able to narrow the window towards the end of this year. The key steps to doing so are that right now, and over the next couple of months, we will be testing and trialling a number of the big computer systems that we have had to develop and also, following a consultation with the market, we will be clarifying precisely how we plan to transition from the current system to the new system. We are still on course for the middle of next year and I hope we will be able to be more precise about that towards the end of this

year. What I do not want to do is announce the date and then discover one of our computer projects has not delivered and then have to revise that date. So far, everything internally is going pretty well.

Q51 Kerry McCarthy: When do you think that sterling overnight rates will exhibit the low levels of volatility that we have in the US and eurozone money?

Mr Tucker: I hope shortly after we have introduced the new system, so in the back half of next year. I do not expect a miracle overnight but I do expect substantial progress in the back half of next year. We have already made progress. If you look back three or four years, I mean, frankly, it just was not good and it was damaging the reputation of sterling markets and, more importantly, it was damaging the end users of sterling markets—companies and investors. The announcement that we are going to do something about this has helped to make a difference and some interim reforms that we introduced between March and August of this year have also brought the amplitude down, if you like, from there to around there.

Q52 Jim Cousins: Just to follow on from the previous questions. What conclusions can we draw about your view of the stability of the system from what you have said? Do you think that generally speaking credit risks are underpriced?

Mr Tucker: I think two things really, Mr Cousins. First of all, I think that credit risk is probably better dispersed now than it was five or six years ago, so it is not just held amongst the banks, but is also held amongst insurance companies and pension funds. The key point there is that they have longer term liabilities and therefore are not so prone to have to sell in a panic. As I think we may have discussed before, there is an important question about whether credit risk is underpriced. Views vary on that and the reason they vary is that there have been substantial improvements in the strength of corporate balance sheets in America and in Europe, including the UK, over the past few years. That would help credit risk to come down but they have come down a lot. The risks are two fold. One risk is that there could be an abrupt adjustment at some point and in May we saw a wobble that people thought may become worse than that. It did not as it turned out, but that risk remains present. A second and quite separate risk—on a slower fuse, if you like—is that with long term interest rates as low as they are and with credit spreads as low as they are, it is cheap to borrow and over time companies may again over borrow in the way that happened in the back half of the 1990s. So far, there is not much evidence of the second risk. Companies around the world seem to have been extraordinarily conservative with their holdings of cash, which may be one of the things which has been holding back business investment, not only in this country, but internationally. The basic underpinnings of the system, I think, are sounder than they were 10 years ago. At any particular time there are risks and there are some risks just now of the kind that I have described.

Q53 Jim Cousins: The search for yield is relentless in the context that you have described. We now have huge private equity markets which are effectively unregulated. Does this give you some concern?

Mr Tucker: The search for yield has been fairly relentless—and I am going back over two years or more now—and it would be fair to say that when credit spreads started to rise a bit in March and then when there was this slightly more violent wobble in May, I thought that would have probably made a difference and it has not, and it is indeed a source of risk. I do not think myself it is something to do with the regulated sector and the unregulated sector. Whether it is regulated firms or unregulated firms, a lot of people out there are searching for a little bit of extra yield.

Q54 Angela Eagle: I was intrigued, Mr Tucker, by a concept that you referred to and took some modest credit for in your questionnaire to us and that is this concept of the natural rate of interest which clearly is relevant to your job on the Monetary Policy Committee, if indeed such a thing exists. Do you want to tell us a bit about how you have developed this, or been one of the people that developed it, and what implications that has, in fact, for your job on the Monetary Policy Committee?

Mr Tucker: The idea goes back decades. The best way I think I can explain it is take the current rate of interest, we set a nominal rate of interest, $4\frac{1}{2}\%$. Imagine inflation was currently 5% and it was expected to be 5% for a little bit longer, so the real rate of interest would then be minus $\frac{1}{2}\%$; we would be pumping up the economy like fury. The first step is to say it is not just the nominal interest rate that matters, it is the real interest rate. The nominal interest rate has to cater for what people think inflation is going to be over the near term. The second step is to say now that we have got an approximation of that real interest rate, do we think that is restraining demand or stimulating demand? At the level of the concept, I think it is very important to think in those terms and we have to make individual judgments as to whether we think we are slightly restraining demand or slightly stimulating demand and you cannot get that just by looking at $4\frac{1}{2}\%$ or $6\frac{1}{2}\%$ or whatever it is. I find it useful when I go around the country and people say well, how do you get to $4\frac{1}{2}\%$ to talk business people through that kind of argument and also explain the notion that we can never be quite sure about whether we are stimulating exactly to the degree we wish or restraining.

Q55 Angela Eagle: Do you think it is possible that there should be much more discussion of what the nominal rates and the real rates are in a more upfront way rather than then just being in the heads of the Monetary Policy Committee?

Mr Tucker: I think we do discuss it quite a lot and I think other central banks do too. Certainly, I would like to think I have played my part in ensuring we do.
Angela Eagle: Mr Walton said he was a pragmatic neoclassicist Keynesian synthesis man, how would you describe yourself in the theocracy?

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Q56 Mr Love: Top that!

Mr Tucker: I am trying to. The substance of what David said, I completely agree with him, it is just remarkable the degree of convergence in the economics profession. Mainstream.

Angela Eagle: Mainstream. That is a bit less of a mouthful! Thank you.

Q57 Susan Kramer: Rhetorically, I just wonder if it is not dangerous when everyone is becoming mainstream. All the exceptional events that come in from the side get attention and notice.

Mr Tucker: The consensus is around the underlying workings of an economy. On monetary policy, that leaves plenty of room for differences of view about what is going on at any particular time and what the strategy should be, and I think we have seen that. There was a period over the past two years when we were regularly turning out nine: nil votes/victories and the question coming from the Select Committee and from elsewhere was, was there actually a debate in the Committee and there was. As soon as we came into slightly more nuanced waters, that became apparent via the vote. I do not think you need worry about there being real debate in the Committee. It is not a monolith, and also I think the degree of challenge from elsewhere in the economics profession and amongst commentators is pretty healthy and keeps us on our toes.

Q58 Susan Kramer: In a recent speech, you stated that for some years UK monetary policy has been directed offsetting weaknesses in the external environment by stimulating domestic expenditure. You talked, just a few minutes ago, about a relatively conservative risk profile for business and institutions. Then, you also said that we have been accumulating imbalances in the economy such as the rapid accumulation of household debt, alongside burgeoning house price inflation. You also concede that the strategy of offsetting these external weaknesses with domestic sort of stimulation has always had limits. Are we coming close to reaching these limits?

Mr Tucker: I think a few years ago we came close to reaching them, yes. I refer somewhere in my submission to the Committee having had some luck and I think one piece of luck was that the world economy started to turn up when it did. I think on a previous occasion I think I said it was important that central banks elsewhere did what they could to stimulate demand in their economies and that occurred. Had the world economy remained weak for longer I think that we may indeed have found ourselves stretching the limits of that strategy for exactly the reasons that you describe. Things have moved on slightly since I gave that speech. I do not think the picture is completely transformed, but as you discussed earlier this morning with David, consumption has slowed and the housing market has slowed. We have not got quite the heady excesses that we had for a while. I do not think we are boxed in in terms of the operation of monetary policy in the months to come.

Q59 Susan Kramer: You said “in the months to come”. Since we cannot always rely on the world economy timing these things right the sort of “bail us out of . . .” I do not want to use the word “crisis”, but perhaps “problems”, are there additional tools that you would like to see the MPC equipped with?

Mr Tucker: I do not think there are any other good tools of monetary management. They have been tried in the past and, in truth, they were an abject failure. I think the interest rate tool is the best thing we have got. I think if there are limits to what we can do in particular circumstances, that is when we would have to explain what is going on and maybe inflation would have to undershoot or overshoot for a while rather than build up imbalances to a point where some dislocation was seriously threatened.

Q60 Susan Kramer: You began to vote for increased rates in February because of a degree of excess capacity but resumed voting for no change in May 2005 because of the downside risk to consumption. While I understand, and I quote “You are remaining ready to raise rates if incipient inflationary pressure emerged” if this downside risk to consumption fails to materialise, would the degree of spare capacity still justify increasing rates?

Mr Tucker: As we went into the beginning part of this year, the economy looked pretty tight. Survey measures of capacity utilisation were high, the labour market was tight and actually, quite strikingly, when one went around the country talking to businesses, quite a number—initially I found it surprising—talked about their ability to pass on cost increases. They were gaining pricing power again, and at the February meeting, when our inflation forecast was, in fact, above 2% at two years and going up, I thought we needed to nip this in the bud. Two or three things have happened since then to change the picture. First of all—I mentioned this a couple of times, in my written submission—the extent to which inwardly migrant labour have eased pressures in the labour market was greater than certainly I appreciated at the beginning of this year. And secondly, consumption has turned down more than I think any of us expected, partly because of the oil price rise, partly because of our earlier increases in interest rates against a background of high levels of debt and I think also, importantly, against a background of considerable uncertainty about the housing market. I think that is a much better picture now than it was. I was really quite worried in the autumn of last year about the debate about house prices. My own view was that most likely house prices would move sideways but there was such an atmosphere of gloom developing that there was a severe downside risk that has probably receded a bit since then. I think we have got a different picture now from six months ago.

Q61 Susan Kramer: Given what you just said, could you just tell us why you did vote for no change in rates at the meeting in August?

Mr Tucker: This brings one to oil. This is a finely balanced decision. My own view was that the near term risk was to the downside and there was a case

for taking a precautionary cut in interest rates to offset that downside risk. In the medium term there is an upside risk to inflation from the rise in inflation that we have already seen feeding through into wage bargaining, and the credibility and the stability of inflation expectations that we have achieved are so precious that that has been given quite a bit of weight. If you like, it is a low probability risk but with a high cost if the probability crystallises. I thought we should err on the side of, I did not use the word “caution” but caution, if you like, in August.

Q62 Lorely Burt: Mr Tucker, in a recent speech you said that for some years UK monetary policy has been directed at offsetting weaknesses in the external environment by stimulating domestic expenditure but that this had been accompanied by accumulated imbalances in the economy such as the rapid accumulation of household debt alongside burgeoning house price inflation. You conceded that this strategy always had limits. Are we coming close to reaching those limits?

Mr Tucker: I think, as I have tried to explain to Mrs Kramer already, a few years back we were coming close to those limits and it could happen again in the future. I do not think we are in that position just now because I think so much has changed in the intervening period since I gave that speech.

Q63 Lorely Burt: Would you say that consideration of household debt was a reason why you did not vote for an interest rate cut in July, August and September?

Mr Tucker: No, the greater reason was the upside risk to inflation through the oil price effect on prices and costs feeding back into wage bargaining. And, as I have said, I think that is a low probability risk, but one with a very high cost if it were to crystallise. But my vote was not motivated by “you must avoid stimulating the housing market”. Again, I have to say, I am pleased and relieved that the housing market has stabilised, but it did not play a key role in my recent votes.

Q64 Lorely Burt: You told us you were leaning against any mis-perceptions of the degree to which the Bank can successfully fine tune fluctuations and demand. Other members of the MPC have pointed out that the cost of debt servicing could be moderated by monetary policy in the face of an adverse shock. Do you think that people should assume that if there is an economic shock there will be an interest rate cut to ease the pain of debt repayments?

Mr Tucker: I do not think it follows as night follows day. I think there can be a presumption in that direction but I think our eyes have always to be on the medium term inflation outlook. This question of fine tuning is one that preoccupies me quite a lot. The regime change during the 1990s, I really do believe can insulate this country against boom and bust and that is good for everyone. I think it is good for businesses and innovation, it helps to make the economy more flexible, and it is good for consumers.

I do not think we can deliver the economy on a flat line. Since the Committee was set up we have barely had a downturn, a fall in aggregate growth, and it will happen one day. I do not know when it will happen, but it will happen. I do not think that will mean the regime has failed or let everybody down. The longer I have served on the Committee, the keener I have become to get it across, on occasions like today—and actually I say this almost in every single business meeting I do now—that we cannot deliver the economy in a flat line. We cannot sustain month by month, quarter by quarter, growth without fail. The job is just too complicated and the world has too many uncertainties for that. It would be an awful thing if the regime were called into question for things that the regime had no capability to deliver. I think we have to lean against any perception that we can successfully fine tune, and there is an element of this in parts of the academic community. Forty years ago academics thought we could fine tune using fiscal policy and there is a body of opinion that maybe we could do that using monetary policy now, and I doubt we can.

Q65 Mr Todd: You have touched on the impact of the oil price rise in the MPC’s decision, could you talk us through the dilemma that the MPC face and how you, particularly, perceive that because obviously there were two potential responses, one was to see this as an inflationary pressure and respond with an interest rate rise to deal with the potential upside impact, the other was to accept that this might be a long-term process and that you would have to accommodate this. How do you see that dilemma and how did you place yourself within it?

Mr Tucker: You are right that it is a dilemma, because “both” is the optimal answer. We are in uncharted territory. The last time the country faced anything quite like this—I have to say it was worse then—was well over a decade ago, well before this regime. I think that tests us all, both in terms of our decisions and how we communicate them. Plainly, there is a negative shock to demand that is weakening the economy a bit and other things being equal would lead to inflation perhaps undershooting the target. Inflation has come up a lot and, as David was saying earlier, part of that is attributable to oil, and for me there is just a little bit too much risk that people will say “I need compensating for that. Inflation is turning high, it is eating into my spending power and I am going to the next wage bargaining round and want compensation for that”. I do not think that commits me to a particular course month by month as we go down the road. In August I balanced it that way. What it means is that we must preserve inflation expectations around the target at around two years, and so we need to follow all of the data we have got on inflation expectations. What has happened so far is that surveys of where inflation will be over the next 12 months have edged up and it would be surprising if they had not; so far, further out, they have remained well anchored. We just have

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to remain vigilant and take all the fine judgments, frankly, on what is happening to inflation expectations.

Q66 Mr Todd: I suppose it also depends on one's expectations of oil prices into the future.

Mr Tucker: It does.

Q67 Mr Todd: How do you factor that unknown into this decision making?

Mr Tucker: This is tremendously hard. We are not, as an organisation or individuals, especially expert in predicting oil prices; and the quite striking thing is that those that are apparently are experts are not very good at it. The one reason for thinking that oil prices might remain firm, maybe even go higher, is that to the extent that this is a demand shock coming from the growth of China—I do not literally mean what I am going to say, but just a picture of it—I wonder how many people in China have a car now, and how many are going to have a car in five years' time and 10 years' time? Something remarkable is happening to the global economy and the lead times for investment in the oil world are fairly slow. I think that leaves me feeling that the oil price is unlikely to come off a lot in the years ahead; I may be proved wrong.

Q68 Mr Love: There will be a lot of very happy oil companies to hear that. In a speech you made recently on monetary policy, you indicated that there was not sufficient appreciation of the scale and significance of inwardly migrant labour and dampening inflationary pressures. What is your view on that, today and is there research being carried out as to the exact impact that is likely to have?

Mr Tucker: I think I was not sufficiently appreciative, to be perfectly honest. It is tremendously hard, in that the view is based largely on anecdote. We have got a few numbers on it but they are not terribly reliable. David was talking about meetings he did yesterday, I did meetings at the British Chamber of Commerce in the North yesterday. There were about 20 to 25 firms in the room and I asked about migrant labour and was it being used, and had it helped to get them through the last 12 months, and there was not a firm around the table that had used migrant labour actively, but one of them said they did know of a firm locally that had. I do not want for a second to present that to you as a realistic picture of what it is like out there. When one is relying on anecdotal data, it is tough. There is an equal probability of my walking into a room where half the room said yes, we have used migrant labour a lot. This is another uncertainty and challenge in what we do just now. I have little doubt that it has helped to dampen the effect of demand pressures for inflation over the past 12 months, partly, of course, because the UK was open to the new Member States in the European Union before some of the other countries in the European Union.

Jim Cousins: The migrant labour in the North East is outward migration. There are some Geordies mixed with the Poles in West London.

Q69 Mr Love: Thank you for that. The reason I asked that is, of course, I think there has been some surprise that there have not been the wage pressures that I think we would have expected in the current circumstances and everyone is looking for an explanation of that. You said earlier in relation to your decision on the Monetary Policy Committee in August—if I can sort of paraphrase it—while in the short term situation you might be sympathetic to a rate cut looking out to two years which is, of course, your primary focus, it did not look as obviously that, you would be sympathetic to that rate cut, and I wondered whether that was related to likely second order impacts and particularly to the possibility that wage inflation might be stoked during that period. Was that a major consideration for you?

Mr Tucker: Now, as I tried to explain earlier, I think it is part of it, yes, because of the oil price rise. I would like to repeat what I said; it is low probability but high cost if it crystallises and one has to weigh the balance of the probability and the cost. That is where I was in August and where I will be in the months ahead. You have to accumulate all the data, you not only have to revise your views on what is happening going ahead, you have to revise your views on what was happening in the past as well. As I said, we could spend a lot of time trying to work out what on earth was happening during a particular phase of the country's economic life and then it turns out that the puzzle was not there in the first place. One just has to go into each meeting constantly revising everything.

Q70 Mr Love: You mentioned about your visit to the North East and earlier on in the questioning by the Chairman you indicated that you have a five day plus week. There is often the criticism made, especially of the Bank employee side of the Monetary Policy Committee, that they are very London-centric and very services-centric. How do you respond to that criticism and how do you ensure that you both get out of London and do not only take into account services?

Mr Tucker: Via the Agency visits, like the kind of thing we were doing yesterday. I have got a dinner this evening with a group of business people, CEOs, finance directors and chairmen. The dinner is in London but the companies that they operate are all over the United Kingdom, these are FTSE companies, all over the United Kingdom and all over the World. It goes with what I said about the data. The data gets revised and therefore the anecdote is absolutely vital. One wants to see whether the anecdote, the surveys and the data are all aligned. It is an absolutely integral part of what we do. In my own case, I also travel abroad a lot to talk to financial market participants and, if you like, that is serving both my executive job and also my job on the Monetary Policy Committee.

Q71 Ms Keeble: A small question, which is based on that, which is also about the way in which you get and assess regional data and other data. You have mentioned quite frequently your visits and so on which has been very interesting. It is also very

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interesting that when it comes to something which is politically, and one would have thought economically sensitive, which is about the impact of migrant labour as a labour market factor on the economy, that you said you did not have clear data and you are relying on anecdote. I think it was either you or your colleague that mentioned about the database. How do you ensure that the regional data you get is representative and thorough and that the contacts you have, while they can be very colourful in comparison with being based in London, that they are actually relevant and properly reflect what is happening? How do you then go through a process of assessing that and weighing it up against the other factors which sometimes are much more substantial when it comes to making your decision.

Mr Tucker: I think what the members of the Committee do ourselves are snapshots and I do not think would deliver what you are getting at. I think the key part of that is the agencies that we have based in 12 parts of the country, and they are out there all the time with their deputy agents, talking to their contacts, of which there are about 8,000. One quite important comment on that: we have made some improvements to this, but the balance between manufacturing and services and their contact base does not reflect the balance of manufacturing and services in the economy. It is weighted slightly more to manufacturing, simply because there are so many small services companies. We try and get to those through local surveyors, accountants, lawyers and bankers and so on. What they do, they present to the Committee in a joined up way each month, when we get briefed on the Friday before the policy meeting on the following Wednesday and Thursday, so that is put alongside the data; is a kind of compare and contrast process, if you like. What we try and do is distil questions when they do not appear to fit together. It is a tremendous process for generating questions and the right things to look at. I do not think it can ever give us definitive answers.

Q72 Ms Keeble: Can I come back once again. I think the regional agents are extraordinarily good because we sometimes host sessions for them, and obviously that is a very important role and a very constructive one. How proactive is the Committee in terms of not just receiving the data but ensuring that the processes and the consultative mechanism, (which again it is very easy for one sector to sort of capture somebody) are properly reflected and they do capture all the different aspects that need to be considered including the labour market aspects in a rigorous and systematic way?

Mr Tucker: They have score charts, which we now publish, and so those are open for public scrutiny. That is one level that I think goes towards delivering that. Another is that most months the Committee decides on a question which we would like to have answered, a special question alongside what they are normally doing; and the agents themselves have no control over the questions that we ask, they just have to ensure that they have got a contact base which can deliver the best answers that are available to them.

Q73 Ms Keeble: You do not scrutinise the contact base?

Mr Tucker: I think I have said that the contact base is weighted more to manufacturing than in the economy as a whole. We do sufficient scrutiny to identify that. It is difficult to redress it completely. We have made progress on that in recent years.

Q74 Jim Cousins: You gave us a wonderful phrase in the course of our discussions this morning. You said that “The regime change that occurred in 1997 to monetary policy can insulate against boom and bust”. Well, we are all New Labour now, but the Governor seems to be becoming post New Labour, if I can put it like that, because in his recent speech he says, “The business cycle has not been abolished although monetary policy can affect its amplitude”. He finished by saying, “There has grown up, in recent years, a false sense of our ability to maintain a smooth and steady growth rate of output”. So you are being New Labour, but the Governor is being post New Labour, do you think there might be some tensions?

Mr Tucker: I agree with what he said and in fact I have been urging colleagues to get across precisely this message for some while, and I have been trying to do so. We cannot abolish the business cycle; the business cycle does not equate to boom and bust. On boom and bust, we cannot prevent boom and bust in particular sectors, we saw pretty close to that in telecom and ICT a few years ago; we skirted with that in the housing market. We should be able to prevent boom and bust across the economy as a whole in the way that we experienced all too many times in the past. And the Governor does not need me to speak for him but I am pretty sure that he would agree with that.

Chairman: Mr Tucker, thank you very much. The description of yourself as “A mainstream economist” is admirable when you compare it to Mr Walton’s mouthful on that. So with that in mind, would you give him some lessons in brevity before he appears before this Committee again. However, thank you very much for your attendance and the work you have done in the past session with the Monetary Policy Committee. We wish you every success in your re-appointment. Thank you.

Written evidence

Treasury Committee Questionnaire ahead of appointment hearing for Mr David Walton

A. PERSONAL AND PROFESSIONAL BACKGROUND

1. *Do you have any business or financial connections or other commitments which might give rise to a conflict of interest in carrying out your duties as a member of the MPC? Are there any relevant personal or other factors of which the Treasury Committee should be aware in considering your appointment?*

I have no conflicts of interest concerning my duties as a member of the MPC. My appointment to the MPC was on a 3-day a week equivalent basis (the terms and conditions were determined by the Court of the Bank of England). I have since accepted the post of Visiting Research Professor in Monetary Economics at the University of Oxford on a part-time, 1-day a week equivalent basis. This has been approved by both the Chancellor and the Governor of the Bank of England. They also agreed that I could continue to serve as Chairman of the Society of Business Economics, though I have stood down from the Society's Investment Committee.

2. *Do you intend to serve out the full term for which you are appointed?*

Yes.

3. *Please explain how your experience to date has equipped you to fulfil your responsibilities as a member of the MPC.*

I have more than 20 years' experience as a professional economist, much of it spent analysing and forecasting the UK economy. My career began in September 1984 as an economist with HM Treasury working, first, in the Economic Briefing division and, subsequently, in one of the monetary policy areas. After gaining a Masters degree in Economics from Warwick University, I joined the economics team at Goldman Sachs in October 1987, eventually becoming Chief European Economist. Throughout my time at Goldman Sachs, the economics team was regarded as one of the best in the City for its analysis of the UK economy. During this period, I published many articles of relevance to monetary policy (a representative list is attached). I served as a specialist adviser to the Treasury Committee on both monetary policy and fiscal policy issues during the last two parliaments.

B. ACCOUNTABILITY

4. *How important do you think it is for MPC members to be subject to ex post parliamentary accountability? Could the current procedures be improved?*

The MPC seeks to achieve the inflation target set by the Government and, subject to this, support the economic policy of the Government. Hence it is very important that MPC members are accountable to Parliament for their actions. The MPC does this in a number of ways: issuing minutes of each meeting; publishing a quarterly Inflation Report; writing an open letter to the Chancellor if inflation deviates by more than one percentage point from target; and by members giving speeches and interviews. Given the closeness of the vote at my first two MPC meetings, I thought it was important to give a speech at an early opportunity to set out my reasoning. I delivered this to a business audience in Exeter on 16 September. I also believe that accountability is enhanced by the Treasury Committee probing the views of individual MPC members in regular face-to-face meetings. I think the current procedures work well and I have no suggestions at this time for improvements.

5. *If you were to make yourself available for reappointment to the MPC at the end of your term, what criteria should be used to assess your individual record as an MPC member?*

Whether or not I wished to be reappointed, I would hope to be judged, internally, on my contribution to the MPC's decision making; and externally, on my contribution to building and maintaining a consensus for low inflation. One part of the latter is to try to ensure that the Committee hits the inflation target but it also involves communicating clearly the reasoning behind our decisions, something I tried to do in my Exeter speech.

C. MONETARY AND ECONOMIC POLICY

6. *How might the post-1998 monetary policy control system be improved? Is the framework of an explicit symmetrical inflation target the best within which to conduct policy?*

The monetary policy framework, since the Bank of England was made independent, has worked extremely well. During this period, despite a number of potentially severe shocks to the economic system (eg the bursting of the internet bubble, 9/11 and, more recently, a sharp rise in oil prices), inflation has remained close to target. At the same time, the economy has grown steadily and unemployment has remained low and stable. A symmetric inflation target is important since it provides an assurance that the MPC will try to avoid deflation as well as excessive inflation. And by making the target explicit, the private sector does not have to second guess the MPC's intentions, thereby helping to anchor inflation expectations at the target. At the same time, the framework has sufficient flexibility to allow the MPC to use its judgement how best to respond to shocks; the open letter system—should inflation stray more than one percentage point from its target—ensures that the Committee is accountable for its actions. In my view, it would be hard to improve on this framework.

7. *What factors do you think have led to the increase in CPI inflation over the last 12 months? How far does it reflect pressures of demand on supply within the UK economy?*

It is impossible to allocate precisely the causes of the increase in CPI inflation from a low of 1.1% in September 2004 to 2.4% in August 2005. Between one-third and one-half seems attributable to higher oil prices, both the direct effect on petrol prices and the indirect effects working through the supply chain. Part of it may also reflect the pressures of demand on supply. In particular, revisions to the National Accounts in July substantially altered the path for market sector output such that growth was much stronger during 2003 and the first half of 2004 than previously estimated by the ONS and much softer thereafter. This could have contributed to some of the pickup in inflation observed over the past year. But it is also interesting to note that CPI inflation has picked up much more sharply than RPIX inflation over the past year. While the MPC's remit refers to CPI inflation, it suggests to me that we should be careful not to over-analyse very short-term movements in this, or any other individual, measure of inflation.

8. *How does the measurement of public sector output affect estimates of spare capacity and inflationary pressures within the UK economy?*

When considering inflationary pressures within the economy, it may be more appropriate at times to consider the private sector resources being absorbed by the government rather than the real consumption of the government or the quantity of value-added that it produces, much of which is not traded. This distinction is particularly relevant in times when there is a rapid increase in nominal government spending, such as that which has taken place since 1999. Methodological changes in the way in public sector output is measured would have very little impact on my estimate of spare capacity in the economy because I derive this mainly from survey measures of factor utilisation and labour market tightness.

9. *What do you regard as the main risks to the MPC's forecasts for GDP growth and CPI inflation contained in the August inflation report?*

I believe that there is a downside risk to the MPC's central projection for growth which, in turn, creates a downside risk for inflation further out. Household spending growth, in particular, has been weak during the first half of this year. Although these data could yet be revised higher, a further period of subdued consumption growth seems quite likely. Higher oil prices and a loosening in the labour market will curb the growth of household real incomes. And households' willingness to borrow to maintain spending growth may be limited by their existing high levels of debt. Prospects for business investment are also very uncertain. Business investment has been fairly soft in recent quarters and surveys of investment intentions have eased despite favourable financing conditions. Companies might remain reluctant to invest in the face of increased uncertainty about demand and profitability associated with high energy prices.

10. *How great is the risk to UK growth and inflation posed by high oil prices? How should monetary policy react to higher inflation caused by increased oil prices?*

Oil is a big uncertainty for the outlook for both growth and inflation. Oil prices have doubled since the beginning of 2004; the oil futures market suggests that much of this increase in prices may persist. High oil prices act like a tax, transferring money from consumers to oil producers: as a result the growth rate of the real consumption wage will be somewhat lower than it otherwise would have been. For example, if oil prices were sustained around current levels, and taking the share of oil in total final expenditure, there might need to be a downward adjustment in the real consumption wage by around 1½% over the next couple of years relative to what would otherwise have been possible.

The oil shock poses a dilemma for monetary policy because it tends to dampen growth and boost inflation. The appropriate monetary policy response depends on how households and businesses react. There is a wide range of possible outcomes. Demand could conceivably soften too much if the necessary downward adjustment to the real consumption wage proceeded too rapidly and damaged confidence. Alternatively, inflation expectations could become destabilised if inflation moves too far away from target, increasing the risk that households will demand higher wages in response to higher consumer price inflation in an attempt to try to maintain their spending power. And we have little idea whether oil prices at these levels will permanently reduce the productive capacity of the economy. For the moment, at least, inflation expectations seem well anchored on the target and wage inflation has not picked up by as much as the rise in the CPI inflation which suggests that the adjustment in the real consumption wage is proceeding without jeopardising the inflation target.

11. *What consideration should be given to the exchange rate and to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles?*

Monetary policy needs to respond to asset prices to the extent that they convey information about the path for consumer price inflation. I do not believe that they should play much of a role in decision making beyond this. I doubt whether we have either the ability to identify asset price bubbles in good time or the instruments to prick them without jeopardising our ability to hit the inflation target. My scepticism dates from observing the UK monetary authorities' attempt during the first half of 1988 to prick one supposed bubble—cutting interest rates to try to stop sterling appreciating against the D-Mark—only to help fuel another in the housing market. But this scepticism has been reaffirmed on at least three other occasions since. Monetary policy would have been too loose if it had tried to prevent the 25% appreciation in sterling during 1996–97. And monetary policy would have been too tight if it had tried to pop the internet bubble and rein back the house price increases of recent years. I'd also note that since only the internet bubble has burst, it is legitimate to question whether there have been bubbles in either sterling or the housing market in recent years.

12. *The IMF recently recommended that “it would be worthwhile for the [Bank of England] to expand the number of key macroeconomic variables for which quantified projections are published”. Do you agree with this statement? Which additional key economic variables should the Bank publish projections for?*

I believe that the Bank of England should be as open and transparent as possible. I would have no objection, in principle, in publishing more detail behind the MPC's projections along the lines of those published by most other forecasters. I have two caveats, however. First, the uncertainties around the central projections are as important as the central projections themselves. This is captured by the fan charts in the Inflation Report. Extending the range of fan charts may not help with the MPC's communication. Second, there is a subtle, but important, difference between the Bank's projections and others: for most forecasters, the projections are their best guess, including for interest rates, about what will happen. This is not true for the MPC: the Committee's projections are the best guess about what will happen for a given interest rate path—either constant or marketbased. Since the MPC is able to set interest rates to influence the actual outcomes, the GDP and inflation projections in the Inflation Report are not necessarily a true reflection of the MPC's view of how it expects the economy to develop.

13. *Do you believe that the natural rate of unemployment is a useful concept? On your assessment, where is unemployment currently relative to the natural rate?*

I prefer to use the term “equilibrium” rate of unemployment, or NAIRU, rather than natural rate. It is a very useful concept since it is the unemployment rate that matches demand and supply in the labour market without generating any tendency for wage inflation to rise or fall. Inflation pressures will tend to increase (decrease) if unemployment falls below (rises above) the NAIRU. Like the output gap, it is impossible to measure precisely; the NAIRU can shift through time due, for example, to changes in the structure of the labour market, the tax system and the real exchange rate. But, given the broad stability in wage inflation in recent years, it seems reasonable to believe that the equilibrium rate of unemployment has been fairly close to, or perhaps slightly below, the actual unemployment rate of 4.7% for some time. In judging whether there is slack in the labour market there are other important considerations such as flows to and from those classified as inactive, movements in average hours, and compositional changes in the workforce.

14. *What weight do you place on (a) the monetary aggregates and (b) the output gap in your assessment of inflation prospects?*

There is a positive correlation in the long run between money and prices and it is hard to think of examples of episodes of high inflation that have not been accompanied by rapid monetary growth; hence, money is very important. And it is the job of monetary policy to control inflation. However, the monetary aggregates are not necessarily the most reliable guide to the stance of monetary policy due to variations in velocity that are difficult to predict. In particular, when inflation is low and stable and inflation expectations are well

anchored, it is likely that fluctuations in money growth mostly reflect changes in the demand for money that may be of limited significance for future inflation. And when they are of significance, this should also show up in other indicators. I prefer, therefore, to consider money as one of the many indicators that are available of future inflationary pressure.

The output gap, like the NAIRU, is a very important concept. When output is above (below) potential, domestic inflationary pressures will tend to build (ease). But the output gap is impossible to measure precisely because, like the NAIRU, it is unobservable. I try to infer the size of the output gap from survey measures of factor utilisation, skill shortages, recruitment difficulties and so on, as well as taking into account the behaviour of wages and prices.

15. *To what extent should fiscal policy play a demand management role alongside monetary policy in the short run?*

I believe that demand management should be left primarily to monetary policy—interest rates are much easier to adjust than public spending and taxes, and they are far less likely to distort the supply side of the economy. While it is desirable that fiscal policy is supportive of monetary policy, it is far more important for the Government to set a medium-term-oriented framework for government borrowing and debt.

October 2005

CV

Personal	Aged 42, married with two sons
Education	Tamworth Manor High School, Mitcham 1981–84 Durham University (BA Mathematics and Economics, Class 1) 1986–87 Warwick University (MA Economics, awarded examiners' prize)
Career	October 1984–September 1986 HM Treasury Economist working in economic briefing and monetary policy divisions October 1987–June 2005 Goldman Sachs Managing director and Chief European Economist July 2005—Bank of England Member, Monetary Policy Committee October 2005—University of Oxford Visiting Research Professor, Department of Economics
Research Interests	Monetary and fiscal policy issues in the UK and euro zone, transatlantic competition policy, political economy
Professional Interests	Chairman, Society of Business Economists Member, Royal Economic Society Member of Academic and Policy Board, Oxford Institute of Economic Policy Member of Steering Committee, Warwick Finance Research Institute Fellow, Royal Society of Arts Former specialist adviser—monetary and fiscal policy, Treasury Committee Former member of Handelsblatt/Wall Street Journal shadow ECB Council Former member of economic advisory panel, The Mersey Partnership Former council member, Financial Statistics Users Group
Personal Interests	My family, bridge, sudoku, Italian language and travel, table tennis, cricket, dining out, the Arts.

Treasury Committee Questionnaire ahead of re-appointment hearing for Mr Paul Tucker

MONETARY POLICY FRAMEWORK AND INDIVIDUAL ROLE

1. *What contributions have you made individually to the conduct of monetary policy on the MPC? What lessons have you learned during your period in office?*

Contributions

- This is really for others to judge. Apart from my votes and contributions to the Committee's debates and explaining its and my thinking, I have endeavoured to take an approach to policy making that is focused on the medium-term goals that monetary policy can deliver; and so leaning against any misperceptions of the degree to which the Bank can successfully fine-tune fluctuations in demand. What might be called "rough tuning" should, however, be within our capability.

-
- In speeches and elsewhere I have also stressed the importance of credibility and inflation expectations;¹ and how the past is not a good guide to the future.²
 - There are some contributions that draw on my role as Executive Director for Markets. For example, I publicly explained¹ the implications of the change from an RPIX to CPI target for the interpretation of inflation expectations and real interest rates derived from index-linked gilt prices. In the same vein, I try to offer expert input on credit conditions and financial markets, and so on the interaction between the real and the financial parts of the economy. Judgments have to be made about whether asset price changes will persist, which depends on why they changed in the first place. Where relevant, I try to inject a realistic view about whether financial market movements are dominated by transient noise rather than economic fundamentals. So, for example, at the “pre-MPC” briefing for the Committee on the Friday ahead of its policy meeting, I am active in asking questions designed to shed light on these issues.
 - Amongst others, I may have helped to stimulate interest in the concept of the natural rate of interest.
 - In terms of explaining policy, an example would be presenting the interest rate rises from autumn 2003 as a *process* of gradually withdrawing policy accommodation, and so prospectively returning broadly to neutral if/as the economy recovered as projected, with spare capacity being utilised.

Lessons

I would highlight the following:

- The importance of having a broad strategy in mind when voting month to month. Each month’s decision determines the overnight money market rate for only the next month or so. The macroeconomic effects of monetary policy work through expectations of the path of policy over many months. But we cannot see the future at all clearly and it is important not to offer spurious, and hence misleading, accuracy about the future course of policy. The kernel has to be to explain judgments about the outlook and how we go about setting rates (the “monetary policy reaction function”).
- Rate changes that are made as a precautionary or insurance measure need to be very carefully explained. In particular, it needs to be reasonably clear under what circumstances the “insurance” can/will be removed and so the rate change reversed. In certain circumstances, that might be when, in the event, risks do not crystallise and so outturns—and the outlook—are in line with the central (modal, or most likely) projection. Explaining such policy settings is, perhaps, more challenging if not all majority members regard a cut as insurance/precautionary.
- We can spend a lot of time debating puzzles about what is going on in the economy only to find later, following data revisions, that the puzzle was never really there. This underlines the importance of not getting carried away by month-to-month and quarter-to-quarter fluctuations in the published data. The ONS do a tough job well, but we need to be vigilant about the uncertainty in the data.
- We cannot do enough to stress the uncertainties in our individual and collective judgments, and the margin for error in our policy settings. It sometimes seems that commentators and the markets are rather more confident about the path of rates than are Committee members themselves. As part of conveying our uncertainty, comprehensive minutes are important.

2. What contributions have you made to explaining the work of the MPC and enhancing public confidence in its actions over the last three years?

- Published speeches.
- Agency visits around the country, where I encourage the Bank’s regional agents to balance the visits towards a series of collective discussions rather than individual company visits.
- Talks to groups of business people.
- Answering questions about the framework in the course of financial Market Intelligence meetings with banks, investment managers and others in the UK, USA and elsewhere. In my role as Executive Director for Markets, I see financial intermediaries around the world. I field a lot of questions on the framework, how the Committee operates etc. Given the international nature of today’s markets, and the importance of maintaining credibility in financial markets, our efforts at explaining the regime cannot be confined to the UK.
- Taking questions on financial markets at the quarterly Inflation Report press conference.

¹ For example, “Risk, Uncertainty and Monetary Policy Regimes” at the UK Asset and Liability Management Association, January 2004. See Bank of England *Quarterly Bulletin*, Spring 2004, pp 84–96.

² Eg “Credit conditions and Monetary Policy”, August 2003. See *Quarterly Bulletin*, Autumn 2003 pp 366–378. “Monetary Policy, Stability and Structural Change” at Confederation of British Industry, March 2005. See Bank of England *Quarterly Bulletin*, Summer 2005, pp 247–255.

- On and off-the-record discussions with the press.
- Appearances before the Select Committee.

3. *Given your experience as a member of the MPC for the last three years what suggestions would you make to improve the current monetary policy framework?*

- The framework has worked well so far. Any tinkering would have to be demonstrably necessary to improve the operation of UK monetary policy.
- If the statute were being recast, I would review whether there should be a requirement, in primary legislation, for monthly meetings as opposed to a requirement for a regular published schedule of meetings. Monthly meetings may well be optimal, and have certainly served us well so far, but it is not clear that they should be a statutory requirement.
- We should also keep under review the pros and cons of issuing an explanatory statement after each meeting. To date, issuing a statement only where we have something clear to say, typically when the policy rate has changed, has worked well.
- In terms of the operation of the framework, the Committee keeps the details under review. For example, I welcomed the restructuring of the Inflation Report that created a separate chapter on Supply as this has helped to bring out the analysis behind the Committee's key judgments about demand relative to the supply capacity of the economy.

4. *The IMF recently recommended that "it would be worthwhile for the [Bank of England] to expand the number of key macroeconomic variables for which quantified projections are published".³ Do you agree with this statement? Which additional key economic variables should the bank publish projections for?*

- I do not agree with the statement. It is important to keep attention focused on the key macroeconomic variables; the outlook for aggregate demand/output and for CPI inflation.
- Expanding the range of variables for which we publish projections would risk:
 - creating noise, and potentially confusion, around the key judgment about aggregate demand prospects that we try to communicate cleanly; and
 - fuelling any misperception that the MPC targets them, eg consumption, house prices etc.

5. *As part of your role as Executive Director for Markets, what progress have you made in improving (a) the implementation of monetary policy through open market operations and (b) the provision of analytical and practical input on financial markets to the MPC's deliberations?*

(a) Money Market Reform

- The high-level policy objectives of the reforms were announced in May 2004. Broadly, they are (i) to reduce volatility in the overnight market interest rate; (ii) to strengthen the framework for banking system liquidity management, in normal and stressed conditions; and (iii) to simplify the Bank's operations.
- In April, the Bank published its final plan for a system of monthly "reserve-averaging" combined with a narrow corridor, formed by standing deposit and lending facilities, for the overnight rate of interest. Market interest rates will be set at the MPC's policy rate via the narrow corridor. Volatility should be contained by the system where reserve banks need to hold a targeted level of reserves (deposit balances with the Bank) on *average* over a month rather than, as now, each day. The switch to averaging will also mean that the Bank's open market operations can be a lot less frequent (weekly rather than more than once daily), bringing welcome simplification. I described the analysis behind the new system in a lecture/paper in July 2004.⁴
- The planned system has won warm support across the money market community, including end-user companies and investment managers. A high level of volatility compared with other countries' money markets may have impaired the development of sterling markets. The reforms have also attracted interest elsewhere in the central banking community.
- At present, we are still on course to launch the fundamentally reformed system between March and June 2006, a target range announced in April.
- Interim reforms were introduced over March-August of this year. They have already dampened volatility in overnight money market rates; and have eliminated the feature of the previous system whereby, perversely, the overnight rate would temporarily rise when the MPC was expected to cut rates at its next meeting, and *vice versa*.

³ International Monetary Fund, Staff report for the 2004 Article IV Consultation, para 42, page 27.

⁴ "Managing the Central Bank's balance sheet: where monetary policy meets financial stability", Lombard Street Research, July 2004. See Bank of England *Quarterly Bulletin*, Autumn 2004, pp 359–382.

(b) Provision of analytical and practical input on financial markets

- There has been a lot of innovation in financial markets over recent years. Much of it has unbundled different types of risk so that they can be traded separately. We are alert to these developments, seeking to understand new instruments and the markets in which they are traded. We do this by combining analysis with discussions with market participants.
- Analytically, we have enriched our analysis of wholesale loan markets and the still relatively new market in credit derivatives, which has unbundled transfers of credit risk from the flow of funds involved in loans and bonds. This has enhanced the Bank's analysis of credit conditions. We have also been alert to new instruments that expand the range of financial asset prices we can use to derive measures of market expectations; eg inflation expectations implied by the new market in "inflation swaps". We monitor various options markets, which provide the basis for measures of uncertainty and risk. Drawing on analysis and market intelligence, we have contributed (eg in the regular *Quarterly Bulletin* article) to the debate about why long-maturity yields have fallen.
- As well as understanding the technical features of new instruments, we think it important to get out and about to discuss them with practitioners. Among other things, this helps us to judge when markets are mature and liquid enough to be useful sources of information, and the extent to which prices are being driven by particular features of the market rather than by underlying expectations about economic fundamentals.
- Part of the Bank's Strategy, under Governor King, is to deepen and broaden our Market Intelligence function, which supports both monetary policy and financial stability. We now have a more structured approach internally; and have broadened our range of contacts externally. The mission is as follows:
 - for *monetary policy*, we aim to get behind the noise in core financial markets (interest rates, exchange rates, equities) so that we can draw robust conclusions about expectations of MPC decisions and what is driving asset prices that affect the macroeconomic outlook.
 - for *financial stability*, we aim to understand how global financial markets and the key players in them fit together, in order to identify and highlight emerging risks: to provide forensic intelligence as risks accumulate; and to equip the Bank with the expertise to comprehend, and play its part in responding to, the complexities of a crisis situation. (This work feeds into, eg, the Bank's twice-yearly Financial Stability Review.)
- Our Market Intelligence function ranges more widely than the markets in which the Bank operates, but leverages the Bank's operational roles to establish a global network of contacts (and knowledge). Some of our work was reflected in a speech I gave on "*Where are the Risks?*"⁵ in June of this year.

INTEREST RATE DECISIONS AND ECONOMIC POLICY

6. *Could you explain whether or not you think that the MPC has made any significant mistakes during your period of office?*

- It is really for others to judge. It is fair to say that in some respects the Committee has been lucky, and that in consequence there is a risk that the country may overestimate our ability to stabilise fluctuations in demand.
- Policy errors are made somewhat more likely by the scale and range of structural changes affecting the real economy, and at a time when the economy is still adapting to the new monetary regime.⁶
- We—certainly I—did not initially appreciate the scale and significance of inwardly migrant labour in dampening inflationary pressures stemming from robust aggregate demand growth. The assessment of its significance, and its likely persistence, remains uncertain.

7. *You have dissented from the majority view on the MPC six times. This has always been for higher rates. Why is this?*

- My votes reflected the particular circumstances of each case. I have not seen an underlying pattern to the different episodes of minority voting (counting February—April 2005 as one episode.) For example, I have described my thinking in February 2005 in my answer to question 8. The very different circumstances behind my minority vote to raise rates in October 2003 are broadly

⁵ "*Where are the risks?*" at Euromoney Global Borrowers and Investors Forum, June 2005.

⁶ See "*Monetary Policy, Stability and Structural Change*" (2005).

described in my answer to question 1; essentially, I wanted to unwind the precautionary cut of July 2003, because the international risks prompting it had receded, and so begin the process of withdrawing policy accommodation as the economy recovered.⁷

- I would note that being in a minority means that one has not persuaded colleagues of one's preferred policy course. Month to month that is not terribly important, as the important thing is for policy—and so expectations of policy—to be on the right broad course.

8. *You voted for higher rates from February to April 2005, but in May resumed voting for no change. What factors led to you to begin voting for higher rates and your subsequent change of view?*

- Towards the end of 2004 and into the early part of 2005, I became concerned about the implications of sustained robust growth of aggregate demand for the pressure on the supply capacity of the economy. There was corroborative evidence of a positive output gap from the survey indicators of capacity utilisation, anecdotal evidence from regional visits, and from output price inflation. That seemed consistent with firms initially working their resources harder as the economy recovered but, against a background of an already tight labour market, with nominal earnings pressure likely to build subsequently. That broad view was reflected in the February *Inflation Report*, in which the central projection for inflation was slightly above the 2% target at around two years, and still rising. The published projections assumed modest house price falls, with consequent downside risks to consumption and so, through aggregate demand, to inflation. I thought that it was more likely that the housing market, and prices, would move sideways, and therefore judged that the downside risks were somewhat less than they had been in November 2004 and somewhat less than reflected in the February projections. Taking all this together, I concluded that the policy stance needed to be marginally tighter; and I believed that a forecast month provided an opportunity to explain a tightening.
- By May, my assessment of how the balance of risks should best be reflected in policy had developed, as described in paragraph 38 of the May minutes. While I still saw upside risks to inflation over the medium term, the signs of downside risks to consumption, and so to output, in the near term were more pressing. Given that medium-term inflation expectations seemed to be anchored in line with the target, I concluded that it would be better to hold rates unchanged, while remaining ready to raise our rate if incipient inflationary pressure emerged.

9. *Do you regard the current level of short-term interest rates as accommodative, neutral or restrictive on UK economic activity?*

- Broadly neutral to slightly accommodative. But these judgments, while important, are inevitably highly uncertain.

10. *What factors do you believe have led to the increase in CPI inflation over the last 12 months? To what extent does it reflect pressures of demand on supply within the UK economy?*

- CPI inflation was at 1.1% in Autumn 2004, in the run up to the November 2004 *Inflation Report*. At the time, commentators speculated that inflation might be “stuck” below the 2% target. As it turned out, CPI inflation rose fairly rapidly over the past year. But the big point here is that these are fairly small changes in the measured rate of inflation.
- The underlying factors have been a combination of:
 - pressure of demand on supply;
 - a higher contribution from import prices;
 - the (direct and indirect) effects of higher oil and other commodity prices.
- Re demand pressures, survey indicators of capacity utilisation, although still quite high, have eased back recently, as have labour market conditions. With hindsight, as already indicated, I may initially have underestimated the apparent significance of inward migrant labour, although we will not be able to see the full picture for some time.

⁷ Discussed in a Speech at the National Association of Pension Funds Annual Investment Conference, March 2004. See Bank of England *Quarterly Bulletin*, Summer 2004, pp 234–240.

11. *What do you regard as the main risks to the MPC's forecasts for GDP growth and CPI inflation contained in the August inflation report?*

- In the near term, the principal *downside* risk came from consumption.
- Beyond that, and conditional on those downside risks not crystallising, there was in my judgment an upside risk to inflation from overly accommodative monetary conditions given the extent to which the money market yield curve had shifted down over the previous few months. Money market rates not only embody expectations of the path of the MPC's rate, they are the basis of the real-world rates applied to wholesale and retail financial transactions.
- Separately, there was a small risk of inflation expectations being dislodged if oil prices continued to rise and if the consequently higher inflation outturns fed through into wage bargaining. The risk of dislodged inflation expectations was not highly likely, but would be highly costly if it were to crystallise.
- Monetary policy needs to be conducted with a strategy that addresses that combination of uncertainties; what Chairman Greenspan refers to as "risk management". In terms of communication, the strategy needs to separate out the near-term and medium-term risks.
- There are also various low probability/big impact risks, such as those stemming from global imbalances. In my view, it is often hard for UK monetary policy to address such risks in advance of their crystallising.

12. *What consideration should be given to the exchange rate and to asset prices, including house prices, within the framework for inflation targeting? In particular, how should monetary policy react to asset price bubbles?*

- Asset prices are given a lot of attention by the Committee. They are an important influence on demand conditions, working through wealth, the cost of capital, and the price (exchange rate) at which we trade with other economies.
- House prices are rather different. A rise in house prices increases the amount of collateral available to households to use as security for borrowing, allowing them to consume more in the short run if they would otherwise have been credit constrained. As I have discussed in speeches,⁸ innovation in the financial services industry has made it easier to borrow against any free housing equity. Net and over the medium-to-long run, that reduction in credit constraints should be a good thing.
- Asset price bubbles can, therefore, affect macroeconomic conditions. Nevertheless, I do not believe that monetary policymakers could sensibly embark on targeting asset prices. Principally, this is because we would be trying to hit two (or more) targets at once; and because we do not know enough about the determination of asset prices or what the "right" price is. In particular, we cannot pin down and quantify the factors which, cyclically and over the long run, change the degree of extra yield (the risk premium) that investors demand to compensate for risk.
- There is no denying, however, that asset prices can be a severe complication for monetary policy. One view is that monetary policymakers should "mop up" after a bubble has burst. I have a qualification to that proposition. Policymakers need to take care that the measures they take to offset the impact on aggregate demand of one type of imbalance unravelling do not themselves create or exacerbate imbalances elsewhere in the economy/asset markets; in other words, policymakers need to guard against one imbalance leading to another.

7 October 2005

⁸ "Credit conditions and monetary policy" at Leeds Financial Services Initiative, August 2003. See Bank of England *Quarterly Bulletin*, Autumn 2003, pp 366–378; and "Monetary policy, stability and structural change" (2005).